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diction of this Court was invoked under Section 240(a) of the Judicial Code, and certiorari was granted June 1, 1925. (268 U. S. 686.)

STATEMENT

The Mutual Benefit Life Insurance Company, a New Jersey corporation, sued Duffy, Collector of Internal Revenue, to recover $83,779.70, with interest. The suit, brought in the Supreme Court of New Jersey, was removed to the United States District Court for the District of New Jersey on July 24, 1920. (R. 1.) The suit was to recover excess-profits tax for the year 1917 alleged to have been illegally exacted and paid under protest. Under the provisions of Title I of the Revenue Act of September 8, 1916, as amended by Title I of the Revenue Act of October 3, 1917 (c. 63, 40 Stat. 300), the respondent filed an income-tax return for the year 1917 and paid a tax of $108,500.36. (R. 5.) It also filed, pursuant to the provisions of Title II of the Revenue Act of October 3, 1917, an excess-profits return showing no tax due or payable.

In its return respondent included as part of its "invested capital" under Section 207 of said Act the amount of the legal policy reserve, $186,258,796, required by the State of New Jersey, and claimed a deduction on account thereof under Section 203 of the same Act. Upon audit of the return the Commissioner of Internal Revenue deducted this sum from the invested capital of respondent and also made certain other adjustments (not now in

dispute), the net result being an additional assessment of $83,779.70, to recover which the suit was brought. The case was heard in the District Court upon a motion to strike out the complaint. Judge Rellstab denied the motion, and under stipulation of the parties judgment was entered for the plaintiff for the amount claimed. Upon writ of error the Circuit Court of Appeals affirmed the judgment, which is now before this Court upon writ of certiorari granted upon the application of the Government to review the question stated in the petition, as follows:

QUESTION PRESENTED

Is the legal policy reserve of a mutual life insurance company to be deducted as a liability in computing "invested capital" of the company within the statutory definition of that term contained in Section 207 of Title II of the Revenue Act of October 3, 1917?

THE STATUTE

The pertinent parts of Title II of the Revenue Act of October 3, 1917, Chap. 63, 40 Stat., pp. 300, 302–306, providing for the payment of a War Excess Profits Tax, are as follows:

> Section 200. That when used in this title—
>
> The term " corporation " includes joint-stock companies or associations and insurance companies;
>
> * * * * *
>
> Section 201. That in addition to the taxes under existing law and under this act there

shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year; * * *

Section 203. That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided—

(a) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period (but not less than seven or more than nine per centum of the invested capital for the taxable year), and (2) $3,000; * * *

Section 207. That as used in this title the term, " invested capital " for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

As used in this title " invested capital " does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money

or other property borrowed, and means, subject to the above limitations:

(*a*) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: * * *

THE FACTS

The Mutual Benefit Life Insurance Company is a New Jersey corporation and has conducted the business of mutual life insurance for many years. It has no capital stock and no stockholders. Its assets have all been contributed by its members in the form of premiums on policy contracts. It is a purely mutual company and has always conducted its business on what is known as the level premium plan. (R. 2.)

Under the level premium plan the estimated annual cost of each member's insurance is averaged and the maximum annual premium which he can be called upon to pay is uniform throughout the

life of the policy. A member contributes annually during his early years a sum in excess of the actual cost of carrying his insurance during those years. This excess, augmented by interest thereon, is held by the company as a reserve, which serves to maintain the insurance during his later years, when the level premium would otherwise be insufficient to meet the then cost of the insurance. (R. 2.)

The premiums referred to are the net or mathematical premiums without any provision for expenses or contingencies, to meet which an addition to the net premium is made called "loading." The net or mathematical premium increased by the "loading" constitutes the premium stipulated in the policy. At the end of each year the excess of income over disbursements is ascertained, and after setting aside so much of the excess as is required by law for the increase of the policy reserve each policyholder's share is ascertained and returned to him, either in cash or by credit upon his next annual premium. (R. 3.) The laws of the State of New Jersey and of all other States in which plaintiff does business require as a condition of continuing business that its assets shall not be less than the reserve required by law. (R. 3.)

The amount of the reserve for which the company is required to hold assets is computed annually by the Commissioner of Banking and Insurance of the State of New Jersey and his certificate is accepted by the Insurance Commissioners of all

other States in which it does business except Massachusetts, where the Commissioner makes an independent calculation. The computation of the reserve is based upon an assumed rate of mortality and an assumed rate of interest. The methods of computation are illustrated in Schedule E annexed to the complaint. (R. 8, 9.)

On January 1, 1917, the reserve as computed by the Commissioner of New Jersey was $186,258,796. As computed by the Massachusetts Insurance Department it was $185,638,632. (R. 3.)

A policyholder, while he continues a member of the company, has no right to withdraw a part of the reserve. On surrendering his policy he may ordinarily receive a certain sum in cash or in paid-up insurance and the allowance thus made is never in excess of the reserve. It is generally less, and in some circumstances no allowance at all is made. (R. 4.)

Plaintiff's return for the year 1917 showed a net income of $1,808,339.33, on which it paid an income tax of $108,500.36 and no excess-profits tax. Afterwards the Commissioner of Internal Revenue amended the return in several respects, which are set forth in detail on pages 5 and 6 of the record, and in schedules G, H, and I annexed to the complaint. The result was an additional tax of $83,779.70. The following compilation shows how the amount was computed:

EXCESS PROFITS TAX

Net income for taxable year reduced to		$1,781,815.64
Invested capital for taxable year	$14,719,043.76	
Percentage used in computing deduction	9 per cent	
Amount of deduction for invested capital	1,324,713.94	
Specific exemption	3,000.00	
Total deduction	1,327,713.94	1,327,713.94
Balance subject to excess profits tax		454,101.70
Rate of tax 20 per cent		20 per cent
Total excess profits tax due		90,820.34

INCOME TAX

Total net income for taxable year		1,781,815.64
Less: Excess profits tax		90,820.34
Balance subject to income tax		1,690,995.30
Amount of 2 per cent tax	$33,819.91	
Amount of 4 per cent tax	67,639.81	
Total income tax	101,459.72	101,459.72

SUMMARY

Total income tax for the year 1917	101,459.72
Total excess profits tax	90,820.34
Total taxes due	192,280.06
Original tax paid	108,500.36
Additional taxes paid	83,779.70

It was to recover the amount of this additional tax that the suit was brought, and no fault was found with any of the amendments made by the Commissioner except his deduction of the legal reserve from the amount claimed by the company as its "invested capital." Disregarding details not in dispute, the difference between the Company and the Commissioner of Internal Revenue over "invested capital" was this: The Company claimed that all its assets should be included in invested capital, the Commissioner allowed these assets

minus the reserve. R. 5; Schedule B. R. 7; Schedule H. facing R. 10.

The scheme of the act was to exempt from the excess-profits tax so much of the income for the year as represented the same percentage of invested capital as the "pre-war" income had been of the "pre-war" invested capital,—in any event, however, 7 per cent and in no event more than 9 per cent thereof.

The petitioner in its return made no report of pre-war earnings or pre-war invested capital. It returned its invested capital for the taxable year at $202,685,846.45 and claimed a minimum exemption or deduction of 7 per cent of that amount, which, of course, was far greater than its entire net income. (R. 5, 6.) The Commissioner, in amending the return, computed the Company's pre-war income and pre-war invested capital and found that the average pre-war income was slightly in excess of 9 per cent and allowed the Company a deduction of 9 per cent of its invested capital for the taxable year, together with the specific exemption of $3,000. In computing invested capital both for the taxable year and for the pre-war years the Commissioner refused to allow as part thereof the legal reserve. If the reserve had been allowed it is obvious that no excess-profits tax would have been due. The sole question litigated below and the sole question now before this Court is whether the legal reserve constituted invested capital within the meaning of the

act in question. The District Court held that it did. Counsel for the collector excepted and assigned that ruling as error. (R. 39, 40.) The Circuit Court of Appeals affirmed, and upon petition for writ of certiorari that was the sole question which we asked this Court to review.

SUMMARY OF ARGUMENT

The statute itself defines "invested capital," and to be included therein the legal reserve must fall within the statutory definition.

The legal reserve does not represent cash or tangible property paid in for stock or shares in the corporation, and so is not invested capital within the meaning of subdivisions (1) and (2) of paragraph (a) of Section 207 of the Act.

Nor is the legal reserve of a mutual life-insurance company surplus or undivided profits. It is a liability of the company, the amount of which is computed in accordance with principles fixed by law, and the amount thereof thus ascertained must be charged against the assets of the company as a liability before the company can in any sense be said to have a surplus or undivided profits. This is in accordance with well-understood and fundamental principles of mutual level-premium life insurance, principles recognized and enforced by insurance laws and by insurance departments of the various States. It is also consistent with other provisions of the same and other acts imposing taxes upon these companies. The legislative his-

tory of excess-profits legislation is confirmatory of the plain language of the statute and shows that Congress did not intend that the legal reserve should be regarded as part of the invested capital of life insurance companies.

ARGUMENT

I

To be included in invested capital, the legal reserve must fall within the statutory definition of that term

"Invested capital" as defined by Section 207 is purely a statutory concept. It is not synonymous with invested funds and is exclusive of many things ordinarily regarded as capital. It is a statutory definition restricted by both exclusive and non-inclusive clauses. *LaBelle Iron Works* v. *United States*, 256 U. S. 377.

For the legal reserve of a mutual life insurance company to be included in invested capital it must fall within the statutory definition of that term as found in Subdivisions (1), (2), and (3) of Section 207 (a). The opinion of Judge Rellstab, adopted by the Circuit Court of Appeals, shows clearly that his decision was based upon a reluctance to give the plain language of the statute its full application to the case of a mutual life insurance company. After quoting from a report of the Finance Committee of the Senate, he said (R. 29):

> This declaration by the Senate Committee, as the reason for imposing a war excess-profits tax tends to show that Congress, when

> it dealt with the "war excess-profits tax" provisions of the act of October 3, 1917, did not have in mind enterprises of the character of mutual life insurance companies whose business it is to provide its members with insurance at cost, and which could not make extra gains as a result of war conditions, but, on the contrary, by reason thereof, were bound to suffer increased losses on account of war casualties and epidemics of diseases which usually follow in war's wake, as well as increased expenses in conducting their business.

The courts, however, have no concern with the wisdom or justice of making mutual life insurance companies subject to the same measure of taxation as ordinary business enterprises. In *Penn Mutual Life Insurance Company* v. *Lederer,* 252 U. S. 523, this Court, having under consideration the Income Tax Law of October 3, 1913, c. 16, 38 Stat. 172, and its application to a purely mutual legal reserve company, issuing level premium insurance, said at page 534:

> Nor does the fact that the profit was earned by a cooperative concern afford basis for the argument that Congress did not intend to tax the profit. Congress exempted certain cooperative enterprises from all income taxation, among others, mutual savings banks; but, with the exception of fraternal beneficiary societies, it imposed in express terms such taxation upon " every insurance company."

To this sentence of the opinion the Court appended the following footnote:

> The alleged unwisdom and injustice of taxing mutual life insurance companies while mutual savings banks were exempted had been strongly pressed upon Congress. Briefs and statements filed with Senate Committee on Finance on H. R. 3321—Sixty-third Congress, first session, Vol. 3, pp. 1955–2094.

In the early part of 1917, when Congress was considering the revision of the Income Tax Act of September 8, 1916, by increasing the rate of taxation and by imposing for the first time an excess-profits tax, representatives of various insurance companies appeared before the committees of Congress and protested against increasing the rate of taxation on income and making applicable to them an excess-profits tax. (Hearings before the Senate Committee on Finance, 64th Congress, 2nd Session, on H. R. 20573, pp. 43 *et seq.*)

Exhaustive arguments were presented to the committees of Congress to show that mutual life insurance companies should not be subjected to an excess-profits tax. Congress nevertheless passed the Excess-profits Tax provisions of the Act of March 3, 1917, and included insurance companies without any exception as to mutual companies, and the Act of October 3, 1917, levied an additional income tax of 4 per cent and imposed an excess-profits tax applicable to all insurance companies.

Section 200 of the Act makes the War Excess-Profits Tax applicable to "insurance companies," and Section 201 makes the title apply "to all trades or businesses of whatever description," except those specifically exempted.

It is not claimed, however, that mutual life insurance companies are included in the excepted clauses. Congress did not see fit to draw any distinction between mutual life insurance companies and other corporations in the Act we are now considering, or any prior income-tax legislation. There is no warrant in law for claiming that the definition of invested capital, contained in Section 201 (a), does not apply to mutual life insurance companies and no sound reason has yet been advanced for not applying the definition literally to such companies.

II

The legal reserve of a mutual life insurance company does not fall within the statutory definition of invested capital, as found in subdivisions (1) and (2) of section 207(a)

To be included in Subdivisions (1) and (2) invested capital must be either cash or tangible property paid in for stock or shares of the corporation. *LaBelle Iron Works* v. *United States,* 256 U. S. 377. In that case this Court, referring to this section said, at page 388:

> Cash paid in, and tangible property paid in other than cash, are confined to such as were contributed for stock or shares in the corporation or partnership; * * *.

And again, at page 389:

> It is clear that clauses (1) and (2) refer to actual contributions of cash or of tangible property at its cash value contributed in exchange for stock or shares specifically issued for it; * * *.

This interpretation is in accord with Section 326 (a) of the Act of 1918, Act of Feb. 24, 1919, ch. 18, 40 Stat. 1057, 1092, which adopts the definition of invested capital of the 1917 Act, except that subdivision (1) thereof reads "Actual cash bona-fide paid in for stock or shares."

Inasmuch as the respondent company is a mutual company having no capital represented by stock or shares, its legal reserve is not invested capital within the meaning of subdivisions (1) and (2). If it is to be considered invested capital, therefore, it must fall within the description contained in subdivision (3)—that is, it must be "paid in or earned surplus and undivided profits" used or employed in the business.

III

The legal reserve of a mutual life insurance company is not paid in or earned surplus or undivided profits

The terms surplus and undivided profits in section 207 are evidently used in the ordinary sense. Compare *Edwards* v. *Douglass*, 269 U. S. 204, footnote, p. 215.

To regard the legal reserve of a life insurance company as surplus or undivided profits is to be

wholly unmindful of the fundamental character of level-premium life insurance. Whatever the reserve is, it is not surplus, and it is not undivided profits. If it is, all the modern laws relating to the subject have failed in their purpose and many of the supposed reforms which have been brought about in the conduct of these companies during the past twenty years are imaginary rather than real. According to every known standard of modern insurance accounting or of statutes regulating insurance, an impairment of the legal reserve renders the company insolvent, and to prevent the accumulation of excessive surpluses and undivided profits, (an evil once prevalent), has been one of the chief objects of recent legislation relating to life-insurance companies. There can be no such thing as surplus or undivided profits except such as exist over and above an unimpaired reserve. This is fundamental.

The "legal reserve" at the end of any year is the amount required to meet the liability of the company shown by the "net value" of its policies at that time. Mutual life insurance companies are purely cooperative associations in which each policyholder pays, as nearly as can be computed, the actual cost of the benefit which his contract gives him.

The net or mathematical premium is calculated by taking the duration of life as shown by an accepted mortality table and assuming a given rate of return upon investments. The result is the ex-

act amount which each member of a given class must pay annually in advance, in order to put and keep the company in funds which will enable it to pay, as they mature, all policies of those in the class. To the net or mathematical premium thus computed is added an amount called " loading," to cover expenses of management, contingencies, etc., and the sum is the amount of the annual premium stipulated in the policy. (R. 3.) The legal reserve on any policy at any time (the equivalent of the " net value " of the policy) is the amount of the net premiums theretofore paid on the policy plus interest thereon at the assumed rate, less the cost of carrying the insurance up to that time. It may be computed in either of two ways, producing the same result.

Schedule E, annexed to the complaint (R. 8 and 9), illustrates the two methods of computation. The so-called retrospective method is the method just described. The prospective method (R. 9) is found by deducting the value of all future net premiums from the present value of all policy obligations. See *Moir, Life Assurance Primer,* p. 148; *Eldridge, Principles of Reservation; Fackler, Notes on Life Insurance,* p. 33; *Principles and Practices of Life Insurance,* 8th Ed., (The Spectator Co.), p. 24.

The policy reserve of a life insurance company, together with the value of the future net premiums to be received, represents as nearly as human wis-

dom can calculate it the exact equivalent of the obligation existing at the moment under its policies—an obligation literally as sure as death itself. The reserve calculated in accordance with the experience tables of mortality and the income rate adopted by the company or prescribed by the laws of the State and maintained year by year is what stands between the company and insolvency. An unimpaired reserve is a condition precedent to the continuance of business. (R. 3.) It is only such assets as the company may have over and above this reserve that can ever be regarded in any sense of the word as surplus or undivided profits. That many people believed that it was unwise or unjust for Congress to subject these companies to the excess profits tax can not alter that fact. On the contrary, the fact was a ground for the belief.

The historic Report of the Joint Committee of the Senate and Assembly of the State of New York appointed to investigate the affairs of life insurance companies (Assembly Document No. 41), transmitted to the Legislature February 22, 1906, contains (pp. 418–429) an exhaustive discussion of the surplus of insurance companies. We quote from the Report, page 418:

> A mutual company is based upon the operation of the law of averages. While the duration of the life of any one person is uncertain, the number of deaths which will annually occur among a large number of persons may be predicted almost to a cer-

tainty. Assuming a given rate of mortality based upon experience and a given income from the investments of funds, calculations are made of the amount which should be paid to meet the cost of insurance in a particular case. An additional amount is added to cover estimated expenses and to provide for contingencies, and the result is the fixed premium required. If the actual rate of mortality exactly coincided with the expected rate, if the company realized exactly the anticipated income and if the expenses and contingent necessities corresponded exactly to the provision therefor, there would be no surplus and hence no dividends. The policy holder would receive the insurance bargained for and nothing else.

The Report goes on to point out that the gains of life insurance companies are of five classes:

(1) From mortality due to the difference between the actual and the expected mortality.

(2) From interest or income larger than that expected.

(3) From lapses by reason of a less amount being paid upon lapsed policies than the accumulation arising from the premiums paid.

(4) From loading by reason of expenses and contingencies being less than anticipated.

(5) Profits from sale of property or liquidation of investments.

The Report then continues:

> These gains simply represent the amount which the policyholder has been overcharged for his insurance. In a mutual company or a stock company transacting business upon the mutual plan and issuing participating policies the policyholder is entitled to an equitable return of the overcharge and this is accomplished by the payment of dividends.

The only surplus or undivided profits which a mutual life insurance company may have, therefore, are such as accrue by reason of the fact that the premiums charged are greater than is necessary to pay the claims and maintain the reserve. Most companies in recent years, either because required by law to do so or because of an enlightened policy, distribute these gains annually or at other short periods, either in cash or by credit upon the next annual premium, and this is what is done by the petitioner. (R. 3.) This, of course, does not mean literally that every dollar above the legal reserve is returned and the company reduced to a condition of mere technical solvency. A reasonable "surplus" or special or contingent reserve to meet contingencies is carried for safety. The annual report of the respondent to the Insurance Department of New Jersey showed a surplus of this kind on December 30, 1916, of $8,935,262.05. (See Report of Supt. of Banking and Insurance for year ending December 30, 1916, Part II, p. 21.) This was considerably less than the amount of invested

capital allowed by the Commissioner of Internal Revenue.

In New York as the result of the investigation to which reference has been made companies were required to make annual distribution of these gains and the amount which could be accumulated in the form of a surplus or contingent reserve was carefully restricted. (New York Insurance Law, Section 87; Consolidated Laws, Ch. 28.)

Under the laws of New Jersey when the assets of a life insurance company are not equal to the " net value" of its outstanding policies and other liabilities, the Commissioner of Banking and Insurance may apply for a receiver to wind up the company. (Comp. Stat. of New Jersey, page 2854, Sec. 56.)

Section 86 of New York Insurance Law, c. 28, Consolidated Laws of New York, provides that in estimating the condition of any life insurance company there shall be charged as a liability in addition to the capital stock and all outstanding indebtedness " the premium reserve on policies, and additions thereto in force computed according to the table of mortality and rate of interest prescribed in this act."

The two items which make up the sum of $186,-258,796, which the Commissioner of Internal Revenue refused to allow as invested capital because it was the amount of the reserve liability are set forth under the head "Liabilities" in the annual report of the Commissioner of Banking and Insur-

ance of the State of New Jersey for the year ending December 30, 1916, Part II, page 18. (Compiled Statutes of New Jersey, page 2862, Section 75, requires the Commissioner of Banking and Insurance to make an annual report to the Legislature containing an abstract of the statement of every insurance company filed in his department as required by law.) So far as we have been able to discover, the legal reserve is universally carried as a liability in reports of all life insurance companies. The legal reserve is not a contingent liability but a present existing liability as absolute and certain as is the death of the insured. (*Carr* v. *Hamilton*, 129 U. S. 252.) In that case this Court said, at page 256:

> Every person's interest in life insurance is capable of instant and present valuation, almost as certain and determinate as the discount of a note or bill payable in the future. Tables of mortality and of all values dependent thereon are adopted by every company, and furnish an assured basis of computation for this purpose.

To say, therefore, that the legal reserve of a mutual life insurance company is in any sense surplus or undivided profits is to disregard the essential principles underlying the business recognized by the State Insurance Laws and Insurance Departments. See *National Life & Accident Insurance Co.* v. *Craig*, 251 Fed. 524; *Fink* v. *Northwestern Life Insurance Co.*, 267 Fed. 968.

By a supplement to the General Tax Act of New Jersey, approved May 11, 1906, P. L. 418, life insurance companies are assessed and taxed upon the value of their property and entitled to deduct from the amount the value of their debts and liabilities, including in their liabilities the "value" of their policies according to the computation made by the Commissioner of Banking and Insurance. See *Mayor, etc., of Newark* v. *State Board of Equalization,* 81 N. J. L. 416.

If the amount of the legal reserve is deductible as a liability for purposes of State taxation, how can it at the same time be surplus and undivided profits for purposes of Federal taxation? The rule of New Jersey that the legal reserve represents a debt or liability is also the rule of New York, where it is held to be a liability and not surplus. *Greeff* v. *Equitable Life Assurance Society,* 160 N. Y. 19.

The rule of New York and New Jersey also prevails in other States, where it is held that the reserve fund is a liability of the company. *Equitable Life Ins. Co.* v. *Board of Equalization,* 74 Iowa, 178; *Hawkeye Ins. Co.* v. *Board of Equalization,* 75 Iowa, 770; *Alabama Gold Life Ins. Co.* v. *Lott,* 54 Ala. 499; *Michigan Mutual Life Ins. Co.* v. *Common Council of Detroit,* 133 Mich. 408; compare *Commonwealth* v. *Berkshire Life Ins. Co.,* 98 Mass. 25.

The reserve of a life-insurance company is no more surplus and undivided profits than are the

deposits in a bank. The annual addition made to the reserve does not represent an addition to its surplus and undivided profits any more than does the increase in deposits of a bank. While the amounts deposited in a bank belong to it in the sense that it has title to them, and are loaned and invested by the bank, and in that sense are invested funds, nevertheless against them must be charged as a liability all that it owes to its depositors. And it is only such assets as remain after its obligations to its depositors have been charged as a liability that represent in any sense surplus or undivided profits—that is, invested capital within the meaning of Section 207 of the Act we are considering. The net additions made each year to the reserve represent the then value of the net additions made to its liabilities. The analogy between the premiums in level-premium life insurance and deposits in savings banks was recognized in *Penn Mutual Life Ins. Co.* v. *Lederer*, 252 U. S. 523, 534. The method adopted by the Commissioner of Internal Revenue in computing capital of the respondent company was the same as that used in computing the invested capital of a bank. In the case of a bank the deposits are included as assets, but for the purpose of determining the invested capital the amount of the deposits is deducted as a liability. So from the assets of the Insurance Company must be deducted the "value" of its

policies—that is, of its obligations to its policyholders, in other words its reserve, before it can be said to have any surplus.

This construction of Section 207 is consistent with the provisions of the Capital Stock Tax Act and the income-tax provisions of this and other acts permitting insurance companies to deduct from gross income the annual net additions to the legal reserve.

Section 407 of the Revenue Act of September 8, 1916 (c. 463, 39 Stat. 756), provides for the payment of a capital stock tax by corporations, including insurance companies, based upon the fair value of capital stock, including surplus and undivided profits. The Act, however, contains a proviso that the legal reserve shall not be included as part of surplus and undivided profits for the purpose of the tax, the proviso being:

> *Provided,* That in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included.

In the case of foreign insurance companies, the tax is levied on the capital actually invested in the transaction in the business in the United States, but here, too, is a proviso that the legal reserve shall not be included as part of the cash actually invested. Similar provisions are found in Section 100 of the Revenue Act of 1918, c. 18, 40 Stat. 1057.

So, too, the net additions required by law to be made within the year to reserve funds have been deductible from gross income, under Section 38 of the Corporation Excise Act of August 5, 1909 (c. 6, 36 Stat. 112); Section II, G (b), of the Revenue Act of October 3, 1913 (c. 16, 38 Stat. 114, 173); Section 12, Title I, of the Revenue Act of September 8, 1916 (c. 463, 39 Stat. 756, 768; as well as by the Revenue Act of 1917, which amended the Act of 1916, only by increasing the rate of tax.

The deduction of the net addition to the reserve funds required by law, allowed in all the Revenue Acts as a proper deduction from gross income, was a clear recognition of the fact that such portion of the premiums received as became part of the reserve of the year was no part of the net income to the company, for it was immediately balanced by a corresponding increase of liability.

That the legal reserve of a mutual life insurance company was not within the statutory definition of invested capital was the claim made by Mr. Rhodes, Vice President of the respondent company, before the Senate Subcommittee on Finance, when the excess-profits tax imposed by the Act of March 3, 1917, was under consideration.

We quote from Hearings before the Senate Subcommittee on Finance, 64th Congress, 2nd Session, on H. R. 20573 as follows, p. 48:

> Mr. RHODES. * * * I am trying to be conservative in my statements. Now, this bill says what? We do not know precisely

what, except that insurance companies are to be taxed under it the same as a commercial business; but we are not taxed the same as a commercial business. A commercial business can deduct from its taxable net income, as shown in its income tax return, 8 per cent of its actual capital invested, and it need pay no tax on that 8 per cent. But what can a mutual life insurance company deduct from its taxable net income? It has no actual cash paid in such as is referred to in section 202. It has no actual cash value at the time of payment of assets other than cash paid in. If, as I assume, that means the actual cash value of property other than cash represented by shares of stock, has it any paid-in or earned surplus and undivided profits which are used or employed in the business? We might possibly get 8 per cent of the amount that we are holding as a contingency reserve aside from this specific exemption of $5,000, and that is all that we could get if we get that.

Senator THOMAS. In your annual statements, do you not give figures showing what you call your surplus and also what you call your profits?

* * * * *

Mr. RHODES. That question of profits has a very essential bearing upon this matter. We have a contingency reserve or surplus—that is, over and above our required liabilities, the liabilities that the insurance departments of

several States require us to put up—of $9,682,000.

Senator THOMAS. That is your surplus?

Mr. RHODES. That is what you might call surplus. It is held to meet contingencies. There was a time when life insurance companies held large surpluses and those large surpluses were at times subjected to abuse. That has been done away with with the reforms that have been instituted in life insurance. Their surpluses to-day are limited by law. They can not hold them. That $9,682,000, gentlemen, of surplus that we hold is just about 1 per cent of our contingent liabilities. It is there to meet any contingency that arises. Every dollar of our income over and above that and what is used to pay our running expenses is returned to the policyholders.

And at page 52:

Mr. RHODES. If this bill should be amended, sir, so as to provide that before we were taxed we should deduct 8 per cent of our invested reserve, we would be on a par.

Senator SMITH. What is the language of the bill that you think reaches you?

Mr. RHODES. That section 200, "That when used in this title—the term 'corporation' includes joint stock companies or associations and insurance companies." Not stock insurance companies; all insurance companies.

Senator SMITH. I understand. Now, how does the language reach you even then?

How does it describe a net profit that you make?

Mr. RHODES. Under section 201 we have this language [reading]: "That in addition to the taxes under existing laws there shall be levied, assessed, collected and paid for each taxable year upon the net income of every corporation and partnership organized, authorized, or existing under the laws of the United States, or of any State, Territory, or district thereof, * * * a tax of eight per centum of the amount by which such net income exceeds the sum of (*a*) $5,000 and (*b*) eight per centum of the actual capital invested."

Section 202 further provides: "That for the purpose of this title, actual capital invested means (1) actual cash paid in," of which we have none; "(2) the actual cash value, at the time of payment, of assets other than cash paid in," of which we have none, if that means property represented by shares; "and (3) paid in or earned surplus and undivided profits used or employed in the business."

There is your definition of actual capital invested, which does not apply to a mutual insurance company.

(a) The opinion below

The fundamental error we have already referred to. With the conviction as a point of departure that Congress did not have in mind mutual life insurance companies, the Court tried to find an analogy between the capital, surplus and undivided

profits of ordinary stock corporations and the invested funds of a mutual life insurance company. In the first place, no search for analogies is called for, as the language of the statute is plain and the meaning of the terms used well understood. In the second place, the analogies found were based upon a misconception of the law and the facts; for instance, the court said (R. 34):

> These members—policyholders—are analogous to shareholders in a stock corporation. Subdivision (1), par. (a), of sec. 207 of the revenue act of 1917 is not expressly restricted to cash paid for shares of stock, and if mutual insurance companies are to be subjected to the imposition of war excess-profits taxes, then by analogy so much of the premium payments made by such members which is in excess of the actual cost of the insurance should be held to come within such subdivision and be treated as "invested capital."

This disregards what was said by this Court in *LaBelle Iron Works* v. *United States*, 256 U. S. 377, *supra*. It also misconceives the nature of so much of the premiums as "is in excess of the actual cost of the insurance." That portion of the premiums which becomes part of the reserve is necessary to cover the actual cost of the insurance. The portion which is in excess of the cost is returned, with the exception of such portion as is retained and accumulated in the interest of con-

servative safety as a surplus. It is that surplus which the Commissioner treated as invested capital.

Again, the court erred in drawing an analogy between the reserve and the surplus referred to in subdivision (3). The court, referring again to the premiums being intentionally made larger than necessary to defray cost, said (R. 35):

> Therefore, all that part of these premiums that is larger than necessary for cost insurance is, by analogy, paid in, either as capital or surplus, for the purpose of carrying on the insurance business in which the members are mutually engaged. As a part of these excess payments in premiums are carried into the legal reserve, at least so much of this reserve as represents redundant payments of premiums becomes capital or surplus and falls within subdivisions (1) or (3) or possibly both, and are as much "invested capital" as any cash paid for shares by shareholders of a stock corporation or earned or paid-in surplus used and employed by such corporation in its business.

Here, again, is repeated the error that the reserve is made up of redundant payment of premiums. The Court has confused the "net or mathematical" or actuarial premium, based upon experience tables and a given rate of return, with the premium charged the policyholder, which is the mathematical premium plus loading. (R. 3.) To be sure, the level premiums, which remain the same throughout

life, are greater in the early years than would be the "natural" premiums for those years, just as they are less during the later years. Level-premium insurance averages the premium over the entire period and in the early years builds a reserve to take care of the later years, but it is a misconception to say that the reserve represents a redundancy at any time. Every dollar of the reserve is, in contemplation of law, necessary to enable the company to perform its contract, and no part of it could be returned, waived, or otherwise disposed of without impairing the solvency of the company. The only redundancy is from excessive loading.

The court also was impressed by the seeming injustice which would result to a company which kept its premiums closest to the mathematical cost and did not accumulate a surplus. Such a company would pay a greater *pro rata* excess-profits tax than the company which charged high premiums and accumulated a large surplus. The same condition is true of commercial companies. Upon the same income a small surplus or invested capital results in a large excess-profits tax, while a large surplus or invested capital results in a small excess-profits tax. This was one of the obvious evils of the system. Its effect was to penalize conservative business. The answer, however, is that Congress passed the Act and it must be followed even though it produces, in individual cases, results which seem strange. That it was found to produce uneconomic

results was doubtless one of the reasons why Congress repealed it in 1921. The wisdom of the excess-profits tax is not a concern of the courts.

IV

The legislative history shows that Congress did not intend that the legal reserve should be included in invested capital

As a matter of fact, the inclusion of a provision allowing the legal reserve as a part of invested capital was urged upon Congress when the passage of the first Excess Profits Tax Act of March 3, 1917, was under consideration. See Hearings before the Senate Subcommittee on Finance, 64th Cong., 2d sess., on H. R. 20573, pages 45, 52, et seq.

It was again urged when the Revenue Act of October 3, 1917, was under consideration, and the following amendment was suggested:

> That title 2, section 202, of H. R. 4280, entitled "A bill to provide revenue to defray war expenses, and for other purposes," is hereby amended so as to read as follows:
>
> "SEC. 202. That for the purpose of this title actual capital invested means (1) actual cash paid in; (2) the actual cash value of property paid in other than cash, stock, or shares of such corporation or partnership at the time of such payment; and (3) paid-in or earned surplus and undivided profits used or employed in the business and *including the invested reserve funds of insurance com-*

> *panies.*" (Brief on behalf of Massachusetts Mutual Life Insurance Company. Hearings before the Senate Subcommittee on Finance, 65th Cong., 1st sess., on H. R. 4280, page 258.)

And again when the Revenue Act of 1918 was under consideration an amendment to include reserves as invested capital was submitted by Mr. Hedges, on behalf of the Association of Life Insurance Presidents, as follows:

> Therefore I submit to the wisdom of the committee that section 2, an amendment to the act of October 3, 1917: Section 207, paragraph A, subdivision A, after the words "paid in or earned surplus," that there shall be added these words: "including the reserves required by law to be accumulated and maintained by life insurance companies." (Hearings before the Committee on Ways and Means on the proposed Revenue Act of 1918, Part 1, page 800, and see also statement at bottom of page 811.)

The whole history of the profits tax shows that from its inception insurance companies have endeavored without success to have incorporated by express language a provision that the legal reserve shall be included as "invested capital." In each of three successive acts Congress refused to adopt the proposed amendment. There can be no doubt about what Congress intended.

CONCLUSION

For the reasons stated the judgment below should be reversed.

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NEWTON K. FOX,
Special Attorney Bureau of Internal Revenue.
SEPTEMBER, 1926.